TAX ACCOUNTING FOR AGRICULTURE

Selected Applications of an Application of an Application

BY R. T. BOEHM*

The presumption is that Congress intended a simple method, one that a plain man could understand. Algebraic formulae are not lightly to be imputed to legislators . . . Circuit Judge Hough, *Edwards* v. *Slocum*, 287 Fed. 651, 654, 2 A.F.T.R. 1879, 1882, 1 U.S.T.C. ¶72 (2d Cir. 1923).

Accounting in its usual sense is an art which attempts to measure the approximate flow of economic values through an enterprise, commercial, industrial, agricultural, charitable or governmental.

The measurement is the end result of processes which start first at the collection of information. It follows through the recording and organization process through a variety of techniques known in their simplest form as bookkeeping. The process extends into such advanced methods as mechanized procedures.

The assembly and organization process are specialized adaptations to the need for the discovery of facts. These facts in turn become the minor premise in syllogistic reasoning. Interpretation in the light of generally accepted principles of accounting[1] are adaptations to the major premise found in the substantive content of the principles. Review of the presentation to the outside world after scrutiny by professionals exercising independent judgment applying accepted standards has come to be the highest function of the accountant.

Specialized applications of accounting methods have become a part of the governing process. Since the objectives are often different, differing

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Borrowing a device from authors who turn out more significant work, we wish to dedicate this little piece to Jacob Rabkin of the New York bar. His latest jewel epitomizes the suffering in any attempt at authorship, however unpretentious. "The veteran draftsman knows that there is no such thing as good writing—there is only good rewriting . . ." *The Use of Forms in Tax Planning,* 42 A.B.A.J. 137, 196 (February, 1956). As an admiring and enthusiastic daily beneficiary of his works, we are eager witness that Jake's work shows good rewriting. We hope that our *rewriting* reflects our labor pains even a little after the Rabkin ideal.

[1] "Generally accepted principles of accounting" is a technical term used by accountants in an attempt to describe an objective body of standards. The term connotes a "mixture of axioms, conventions, generalizations, methods, rules, postulates, practices, procedures and standards". Littleton, *Tests For Principles,* 13 ACCOUNTING REV. 16 (1938). See Finney, *Principles and Conventions,* 19 ACCOUNTING REV. 361, (1944), who discussed the absence of definite rules and the reasons. There is much question as to how much professional authority can be exercised. Greer, *To What Extent Can the Practice of Accounting Be Reduced To Rules and Standards?,* 165 J. ACCOUNTING 213 (1938).

methods seem necessary.[2] Tax accounting is only one special application of the techniques which follow ordinary accounting methods in the main, varied by disagreement in principle[3] or by conscious policy.[4]

There are many areas where ordinary accounting principles permit varied interpretations. To some extent, these variations are present in tax accounting. Inventory practices are a ready example of legitimate differences that produce varying results in the attempt to measure the flow of income. See as an example Table B.

In several areas, legislative policy has produced the need for techniques to compute the amount of *non-taxable* income. Percentage depletion,[5] quickie writeoffs by special amortization,[6] accelerated depreciation,[7] and charge-off of conservation expenditures[8] are examples of the adapta-

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[2] Accounting practice for public utilities is strictly supervised. But these standards are irrelevant for tax purposes. Old Colony Railroad v. Comm'r, 284 U.S. 552, 10 A.F.T.R. 786, 3 U.S.T.C. 880 (1932). See Berle, *Accounting and the Law,* 13 ACCOUNTING REV. 9 (1938), and Gutkin & Beck, *Tax Accounting and Business Accounting,* 79 J. ACCOUNTANCY 130 (1945).

[3] A substantial body of exposition has grown up describing the differences between accounting principles and tax accounting doctrine. See among a host of authorities, SMITH & BUTTERS, TAXABLE AND BUSINESS INCOME (1949); and REIMER, DIFFERENCES IN NET INCOME FOR ACCOUNTING AND FEDERAL INCOME TAXES (1949).

[4] In many situations, deviations from commercially acceptable accounting practice have been legislated in order to provide special tax relief. See for example, interest on certain governmental obligations, INT. REV. CODE OF 1954, §103(a), and interest on life insurance paid to a surviving spouse. INT. REV. CODE OF 1954, §101(d). Other deviations have come about because of the need to plug tax avoidance holes. Thus interest paid to earn tax exempt income, INT. REV. CODE OF 1954 §265(2), and deductions between related taxpayers, INT. REV. CODE OF 1954 §267(a), are examples needed to protect the revenue.

[5] The computation of the deduction for percentage depletion requires (a) the determination of "the gross income from the property . . .", INT. REV. CODE OF 1954, §613(a), 613(c), 614, and also (b) the measurement of "taxable income from the property". INT. REV. CODE OF 1954, §613(a). "Algebraic formulae are not lightly to be imputed to legislators" except when necessary to accommodate the demands of the oil and gas interests!

[6] See section III-5 of this paper commencing at page 18 for a discussion of the technical aspects of the fast write-off of grain storage facilities, and note 137 and note 158 for some references to the amortization of defense facilities. See also Table C for an analysis of some of the salient differences.

[7] Accelerated depreciation is new in the 1954 Code as an explicit provision. INT. REV. CODE OF 1954, §§167(b), 167(c); S. REP. No. 1622, 83rd Cong., 2d SESS. 25, 200, (1954). The usefulness of accounting techniques can be found as to taxpayers who are subject to public regulation which requires another method, as for example a common motor carrier subject to the accounting standards of the Interstate Commerce Commission, which requires straight-line methods. See BARNES, THE ECONOMICS OF PUBLIC UTILITY REGULATION, Chap. VIII, *Accounting and Its Regulation,* especially 255 ff. (1942).

[8] See Section III-6 of this paper commencing at page 26 for the ground rules applicable for soil and water conservation deductions.

tion of policies serving to favor certain groups[9] or to accomplish stated policy objectives[10] depending upon preconditioned opinion. They all share in common the need for the accountants' methods with only limited relation to substantive accounting principles.

II—TAX ACCOUNTING FOR FARMERS AS A GOVERNMENTAL TECHNIQUE: INFLUENCING FARMERS ACTION OR MERELY REDUCING TAX LIABILITY?

Tax accounting for farmers is an application of an application of accounting techniques. This symposium presents selected examples from the federal income tax area, covering some standards used in:

(1) Determining a tax treatment for special elements of *gross income* of the farmer by:

(a) Recognition of an optional time of reporting gross receipts arising out of *farmers credit* transactions with Commodity Credit Corporation.[11]

(b) Measurement of the amount of gross income reflected in various *techniques of accounting for*[12] *and pricing* of inventories.[13]

(2) Measuring special tax reductions which arise out of transactions which the government for good reason or questionable motive, desires to encourage and to indirectly subsidize. Special accounting techniques are needed to:

(a) Compute the amount of tax reductions granted to farmers who build their own *grain storage facilities.*[14]

(b) Determine the dollar value of special incentives created to encourage *soil and water conservation expenditures.*[15]

(3) Computing the amount of a farmers tax bill by applying *special tax rate concessions* to situations where the farmer has:

(a) *Replaced permanent livestock.*[16]

(b) Liquidated a frozen asset by *cutting timber.*[17]

(c) Transferred his efforts to a new farm as a result of interference by superior authority, either governmental, by

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[9] See especially chapter and verse mentioned by Professor Cary in his article on pressure groups and favoritism, cited at note 193 *infra.*

[10] A stated objective for the adoption of the "liberalized depreciation methods" was to obtain "maximum incentive effect . . . [and a] stimulus to investment through liberalized depreciation . . . Small business and farmers particularly have a vital stake in a more liberal and constructive depreciation policy . . ." S. REP. No. 1622, 83rd Cong., 2d Sess. 25 (1954).

[11] See section III-1 page 7 *infra.*

[12] See section III-2, page 8 *infra.*

[13] See section III-4, page 15 *infra.*

[14] See section III-5, page 18 *infra.*

[15] See section III-6, page 26 *infra.*

[16] See Moen, *Special Capital Gains Treatment for Farmers, infra* page 32.

[17] *Ibid.*

appropriation, or elemental, by accident, fire or flood, all described as involuntary conversion.[18]

(d) Terminated his investment by *liquidation.*[19]

We would like to be able to think that with certain defensible exceptions,[20] all income will eventually be taxed in one form or another. If this were so, timing is our only problem;[21] and even this is not important where the rates are low and uniform.[22]

But as soon as tax rates go up significantly, the inevitable effect is financial. With a predominant portion of expansion capital coming from an enterprise itself, taxes reduce growth potential.[23] Conversely, if the taxes on the cost of an improvement costing $100,000 can be recaptured in four years, as is possible when the expenditure is made for soil or water conservation,[24] or in five years, when the investment goes for grain storage facilities,[25] it is familiar behavior for the entrepreneur to think in terms of what is at least for the short run a governmental contribution to his economic welfare. The higher tax rates go, the greater the impulse is felt to use this indirect governmental assistance.

But is it demonstrably true on a practical basis, as one treatise has stated,[26] that "the same income is ultimately taxable[27] and the same de-

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[18] See Halstead, *Involuntary and Voluntary Sale of Farm Land, infra,* page 46.

[19] See Moen, *Special Capital Gains Treatment for Farmers, infra* at text near note 33 for sale of a farm with growing crops.

[20] Any request to have certain income exempted from taxation must be defensible by some form of rationalization. The subjective quality implicit in determining defensibility is apparent. See BLOUGH, THE FEDERAL TAXING PROCESS (1952).

[21] See notes 26, 27 and 28 *infra.*

[22] We live with an income levy by the City of Columbus based on certain types of income and taxed at ½ of 1% continuously since 1948. The rates produce a complete apathy about the problems which require planning in the Federal field. Why bother?

[23] The Senate Committee explicity recognized this function of a liberalized depreciation allowance. "Farmers . . . are especially dependent on their current earnings or short-term loans to obtain funds for expansion. The faster recovery of capital investment provided by . . . [INT. REV. CODE OF 1954, §167] will permit them to secure short-term loans which would otherwise not be available ***." S. REP. No. 1622, 83rd Cong., 2nd Sess. 25 (1954). This would accurately describe the effect of any device which serves to reduce a taxpayer's annual exaction.

[24] See section III-6, page ____ infra.

[25] See section III-5, page ____ infra.

[26] P-H 1955 FED. TAX SERV. ¶6065.

[27] Compare for example the value of the inventory of a cash basis farmer at death with the same situation when the taxpayer is on the accrual basis. See note 77 *infra.* Again, what about capital gains from sales of breeding cattle on the two bases? See Table B *infra,* and Moen, *Special Capital Gains Treatment For Farmers,* text at note 30 *infra.*

ductions are ultimately allowable[28] regardless of what accounting method is used?" Is it always safe to say that the only "difference is one of time of reporting?"

It is certainly true that quickie write-offs or a low inventory value in the current year will reduce the deductions available in the years to come. But remember: similar impulses will govern at a later time. Later, after the effect of the amortization device has worn off, the impulse will be to repeat the plan as to another year. In practical effect, in many cases, while the economic value is on hand, the tax is being constantly pushed back to periods yet to come. The factors of production can be seen to accumulate with the assistance of tax subsidies.

This process of extended deferment will in the long run reach a

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[28] We think that deductions will *not* always be the same regardless of the year involved. What about the effect on derivative deductions the amount of which depends upon other deductions first determined? An accounting method and practice may justify different years of incidence of primary independent deductions. For example see the proper time for deduction of taxes. These in turn, when used with statutory limitations based upon net income from the property affect the secondary deduction such as for depletion. *Cf.* Montreal Mining Co., 2 T.C. 688 (1943). The same might be true as to conservation expenditures where no carry-forward will operate under the facts. For individuals under 65 years of age, the limitations on deductibility of medical expenses, INT. REV. CODE OF 1954, §213(a)(2)(B), and for a corporation's charitable contributions, INT. REV. CODE OF 1954, §170(b)(2), are garden variety examples of deductions the amount of which are modified by other deductions or inclusions.

Furthermore, there are occasions where double deductions may come into play. A gift to charity of appreciated assets, such as growing crops or animals, is deductible at the fair market value of the chattel. A cash basis farmer has paid costs to create the value; the costs are not reflected in inventory; the spread between the value of the gift and the recognized tax basis is greater. In effect the cash basis taxpayer gets a double deduction for at least a part of the gift.

This problem has been receiving Treasury attention. At one time, it claimed that the taxpayer realized income to the amount of this spread. I.T. 3932, 1948-2 CUM. BULL. 7, P-H 1949 FED. TAX SERV. ¶76170, CCH 1949 STAND. FED. TAX REP. ¶6044; see I.T. 3910, 1948-1 CUM. BULL. 15, P-H 1948 FED. TAX SERV. ¶76319, CCH 1948 STAND. FED. TAX REP. ¶6178, discussed in Miller, *Gifts of Income and of Property*, 5 TAX L. REV. 1 (1949). The courts did not agree. Alexander v. Comm'r., 190 F. 2d 753, 40 A.F.T.R. 1052, 51-2 U.S.T.C. ¶9418 (5th Cir. 1951); Visintainer v. Comm'r., 187 F. 2d 519, 40 A.F.T.R. 297, 51-1 U.S.T.C. ¶9202 (10th Cir. 1951), *cert. den.* 342 U.S. 858 (1951). Currently an attempt is underway to require the farmer to adjust his costs of production by eliminating the current year's cost attributable to the gift. See Rev. Rul. 55-138, 1955 INT. REV. BULL. 11-15, P-H 1955 FED. TAX SERV. ¶77015, 1955 CCH 1955 STAND. FED. TAX REP. ¶6206 which discusses the cases and indicates an attempt to eliminate the double deduction attributable to the current year. See also Rev. Rul. 55-531, 1955 INT. REV. BULL. 34-17, P-H 1955 FED. TAX SERV. ¶77404, CCH 1955 STAND. FED. TAX REP. ¶6417.

A further example is found in a new ruling that a fixed pledge to a charity may be satisfied by a gift of appreciated property without realizing income. Rev. Rul. 55-410, 1955 INT. REV. BULL. 26-34, P-H 1955 FED. TAX SERV. ¶77261, CCH 1955 STAND. FED. TAX REP. ¶6360.

successful conclusion. At the time of death substituted basis rules[29] intervene so that the market value rule applied to the property of the decedent will restore the higher basis in hands of the next generation. In most smaller cases, the federal estate tax[30] and the local inheritance costs[31] will be relatively inexpensive. Meanwhile the estate, or lifetime spending, has been increased by the taxes saved.

The government, serving all of us, must accommodate itself to the pressure of interest groups and to the basic demands of the profit enterprise system. The Internal Revenue Code is but one facet of the regulatory system of American government as a whole. Any realistic analysis of the practical results of the substantive statutory techniques must face up to the certainty that numerous special objectives are characteristic of the system. In this sense, farmers tax accounting is a euphemism for one technique to accomplish these indirections.

III—Selected[32] Accounting Methods Designed or Operating to Provide Indirect Assistance to Agriculture

We turn now to examine several special techniques that reduce the tax cost of profitable farming or increase the incentives to take up farming as an expensive hobby.[33]

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[29] Int. Rev. Code of 1954, §1014(a).

[30] The specific exemption is $60,000. Int. Rev. Code of 1954, §2052. The marital deduction functions so that an estate passing to a spouse is free of estate taxes until it passes $120,000. Int. Rev. Code of 1954, §2056. The tax bill on a net estate of $220,000 passing to a surviving spouse is $7,000. Int. Rev. Code of 1954, §2001. For this she purchases a new basis for depreciation. Int. Rev. Code of 1954, §1014(a).

For the next generation the tax news is worse. The same estate of $220,000 would have cost $38,700 in the hands of children.

An alert estate planner would want to work out a better plan. If this were the whole picture he would argue for a split plan, with half passing to the spouse and another half passing to the children. This would reduce the cost to the next generation to less than $14,000.00 if we overlook some refinements not a part of this subject matter.

[31] The highest rate levied on successions by spouse, children or grandchildren under the Ohio inheritance tax plan is 4%. Ohio Rev. Code §5731.12. Exemptions are low, never more than $5,000, Ohio Rev. Code §5731.09, but each beneficiary gets his own. But 3% is the rate between $100,000 and $200,000 *on each succession* by spouse or children after the small exemption. Ohio Rev. Code §5731.12(a)(3).

[32] We have only recently learned about a handbook, Taxation of Farmers, soon to be published by The Committee on Continuing Legal Education. Halstead, *Taxation of Farmers; Accounting Methods, Records and Returns,* 1 Practicing Lawyer 57 (1955).

[33] An additional deduction can never do a taxpayer any good unless he has gross income to support it. Here is one good reason why farmers elect to return income from a Commodity Credit Corporation loan. See Section III-1 *infra.* The situation is helped some where he paid taxes in previous years so as to qualify for a refund arising out of the net operating loss deduction. Int. Rev. Code of 1954, §172. The other alternative lies in situations where there is other income

1—*Commodity Credit Corporation Loans*

Funds from the Commodity Credit Corporation, a federal subsidiary, can be used to carry the farmer until he decides to sell his crop. The legal theory for these advances is predicated upon a loan to the farmer. Cynics claim that this is another device to play politics with the farmer; it has been said that there is seldom any intention to repay the loan.[34] If such a sham were present between private individuals or corporations, the loans would be held to be taxable income to the recipient.[35] But the legal fiction cannot be disregarded when the government itself is one party. Consent has been legislated.

Ordinarily a loan made by the Commodity Credit Corporation does not constitute taxable income. In order to allow the farmer to elect to match his income with his loan receipts, special tax consequences were devised to match the credit subsidies. One District Judge has explained their work-a-day effect:[36]

> In recognition of the purposes of the program under which . . . [loans upon commodities by the Commodity Credit Corporation] might be made, some special features were attached to them. Among such features was the immunity of the borrower (with due safeguards touching fraud and the quantity, quality, and grade, and care and preservation or delivery, of the mortgaged commodity) from personal liability of any deficiency in the loan arising from the sale of the pledged commodity. Title 7 U.S.C.A. §1425. In practical operation, when commodity prices at final sale times were unfavorable, the amounts received in the way of loans came to be the prices actually received by the producing borrowers for their crops. Generally too, the proceeds of the corporation's loans were gotten by the producers of the pledged assets in the year of the production of the mortgaged crops when the deduction of the expense of production was appropriate and easy.

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against which the farm deductions can be claimed. If each activity amounts to a business, the results are offset. Danzig, *Losses in One Business, Profits in Another,* 27 TAXES 53 (1949), and Smith, *What Is Deductible For the Auxiliary Enterprise,* 9 N.Y.U. INST. ON FED. TAX. 337, 340 (1950).

Of course, a pure hobby farm does not constitute a business. The expectation of gain properly proven will qualify. U.S. Treas. Reg. 118, §39.23(e)-5. In the final analysis, these constitute fact problems. See dozens of cases collected in P-H 1955 FED. TAX. SERV. ¶¶13662, 13663, 13663A; CCH 1955 STAND. FED. TAX REP. ¶1386.09; RABKIN & JOHNSON, FEDERAL INCOME, GIFT & ESTATE TAXATION, ¶13.06.

[34] See the implication in the controversial article in *Harpers Magazine,* cited note 186 *infra.*

[35] Loans to officers by a corporation have been held to constitute dividends when circumstances indicated that there was no genuine intent to repay. Regensburg v. Comm'r, 144 F. 2d 41, 32 A.F.T.R. 1141, 44-2 U.S.T.C. ¶9412 (2d Cir. 1944), *cert. denied,* 323 U.S. 783 (1944).

[36] Stewart v. U. S., 100 F. Supp. 221, 225, 41 A.F.T.R. 101, 105, 51-2 U.S.T.C. ¶9441 (D.C. Neb., 1951).

> Considerations arising from those sources, along with others, eventually and quite early moved the congress to the allowance of an indulgent option to the borrower respecting the year or years in which reporting for income tax purposes may be made of the proceeds of such borrowings. The pertinent result is Title 26 U.S.C.A. §123(a) and (b) . . .

Under the terms of the option, a taxpayer may elect to consider as income, loans received from the Commodity Credit Corporation so as to include the proceeds of the loan in gross income for the taxable year in which received.[37] For the cash basis taxpayer mailing isn't enough; actual receipt is necessary.[38] If the commodities are later sold for more than the loan, the extra increment must be reported as income in the year of sale.[39] If the sale is for less than the amount of the loan, no deductible loss is realized by the farmer if he is relieved of further liability for the loan.[40] If loans from several years are liquidated in one later year, the gain from one is fully taxable and the losses from the other are not deductible; the transactions cannot be offset.[41]

Once the option has been elected, the method must be adhered to for subsequent years.[42] Permission for a change in method may be secured from the Treasury by application made within 90 days after beginning of the taxable year affected.[43] The election under prior law must have been made by positive action in the return. The election cannot be merely inferred from circumstances, and the election cannot be later asserted by an amended return.[44] When the election has been made and the loan returned as income, an adjustment to basis is required.[45]

2—Selected Farm Accounting Methods

Taxpayers in general may use whatever method of accounting they choose. It must "clearly reflect income"[46] which may mean merely that the books must be kept honestly and in good faith[47] or may mean more, that "the income should be reflected with as much accuracy as standard

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37 INT. REV. CODE OF 1954, §77(a), enacted in 1939 as §123 of INT. REV. CODE OF 1939; 53 STAT. 879; 56 STAT. 848.

38 Sloper, 1 T.C. 746 (1943).

39 U.S. Treas. Reg. §1.77-2(a)(1), T.D. 6147, P-H 1955 FED. TAX SERV. ¶¶23194, 23199.

40 U.S. Treas. Reg. §1.77-2(a)(2). The farmer might be relieved of personal liability. 7 U.S.C.A. §1425.

41 U.S. Treas. Reg. §1.77-2(b). To allow the taxpayer to net losses and gains from different years would allow part of the income from the loan to go tax free, where the farmer was not required to make good the deficiency.

42 INT. REV. CODE OF 1954, §77(b).

43 U.S. Treas. Reg. §1.77-1.

44 Stewart v. U.S., 100 F. Supp. 221, 41 A.F.T.R. 101, 51-2 U.S.T.C. ¶9441 (D.C. Neb., 1951).

45 INT. REV. CODE OF 1954, §1016(a)(8).

46 INT. REV. CODE OF 1954, §446(b), (c), (a).

methods of accounting practice permit . . ."[48] Consistency from year to year is a dominant accounting principle[49] and legal requirement.[50] By current standards, the absence of formal organized records would seem not to deprive the taxpayer of the right to use any method he wishes[51] although under prior law if he didn't keep books, he was not permitted any method except cash receipts and disbursements.[52] Even with this concession, there remains the practical problem as to how the information can be assembled. If he does not keep books, he must use a calendar year for his reporting period.[53] The inadequacy of records introduces the further problem of applying acceptable techniques in the reconstruction of income which is a separate inquiry having enormous scope.

It has been familiar hornbook law that the average taxpayer may use either the cash receipts and disbursements method or the accrual method. Only simple patterns will justify the use of the cash basis which seems to derive its results from the cash register: when the money comes in, its income; when the bills are paid, they're expense.

For most taxpayers as a general rule, accrual accounting practices are required when inventories are a material factor in the production of income.[54] Written inventory records are obligatory[55] presumably because of the dangers to the revenue inherent in short memories and the ease of conscious distortion not easily refuted.

Where inventories are significant, although the Sixth Circuit Court

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[47] In the Sixth Circuit, it is probable that the clear reflection of income means "plainly, honestly, straightforwardly and frankly but does not mean accurately . . ." It does not mean "without error or defect . . ." Huntington Securities Corp. v. Busey, 112 F. 2d 368, 370, 25 A.F.T.R. 82, 40-2 U.S.T.C. ¶9508 (6th Cir. 1940); and Glenn v. Kentucky Color and Chemical Co., 186 F. 2d. 975, 40 A.F.T.R. 139, 51-1 U.S.T.C. ¶9167 (6th Cir. 1951). These authorities have been questioned and the regulations interpreted more strictly. See note 48 *infra.*

[48] Circuit Judge (formerly Yale Law School Dean) Clark in Caldwell v. Comm'r, 202 F. 2d 112, 43 A.F.T.R. 271, 53-1 U.S.T.C. ¶9218 (2d Cir. 1953); *Cf.* Herberger v. Comm'r, 195 F. 2d 293, 41 A.F.T.R. 907, 52-1 U.S.T.C. ¶9253 (9th Cir. 1952), *cert. denied* 344 U.S. 820 (1952).

[49] GENERAL ACCEPTED AUDITING STANDARDS (AMERICAN INSTITUTE OF ACCOUNTANTS) 51 (1954); Blough, *Accounting Principles and Their Application,* (C.P.A. Handbook, American Institute of Accountants) Chap. 17, p. 24 (1953).

[50] U.S. Treas. Reg. 118, §39.41-2 requires "reasonable consistency."

[51] "It is not necesssary to keep books in order to have an accounting method . . ." S. REP. No. 1622, 83rd Cong. 2d Sess. 299 (1954).

[52] We suppose, with some reservations, that Committee comment with the surrounding safeguards in effect have overruled decisions which seemed to mean that a taxpayer who kept no records could not report income on the accrual basis. Greengard, 8 B.T.A. 734 (1927), *sub nom* Greengard v. Comm'r, 29 F. 2d 502, 7 A.F.T.R. 8323 (7th Cir. 1928). A co-participant in this symposium seems to think otherwise. Halstead, *Taxation of Farmers,* 1 PRATICING LAWYER 57, 59.

[53] INT. REV. CODE OF 1954, §441(g)(1).

[54] U.S. Treas. Reg. 118, §39.22(c)-1; §39.41-3(d).

[55] I.T. 1673, II-1 CUM. BULL. 30 (1923); see C. E. Clark, P-H B.T.A. Memo Dec. ¶42098, CCH Dec. 12412-F (1942); U.S. Treas. Reg. 118, §39.22(c)-2(e).

of Appeals seems to think otherwise,[56] the Treasury holds that "no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method * * *".[57] The method also requires adequate adjustment for receivables and liabilities incurred.[58]

Events sometimes don't fit the cut off date of the calendar; taxpayers jump the bounds of strict logic; for one reason or another, they use a hybrid system. The courts have insisted upon full application of the logic of the method in use. Hybridizing was formerly held to be improper.[59] But in day-to-day practice, we have observed that this standard was often overlooked.[60] Under the present Code, if the method of accounting regularly used by the taxpayer clearly reflects income,[61] it is acceptable even though it combines more than one method[62] despite the taxpayers failure to keep books.[63]

While attempts at hybrid accounting faltered and stumbled in the courts, judicial and administrative hybridizing, for good reason and poor, have brought significant intermixture of standards. Departures from strict application of the principles of cash and accrual accounting have been developed so that results flowing from each in some areas bear a practical resemblance to the other, even though the basic theories are different.

The cash method, listening to the sound of the jingle in the till for its elementary test, has been modified by the salutary doctrine of constructive receipt.[64] Notice its strong family resemblance to the accrual-of-right concept in the accrual method.[65] In spite of a shift in the basic

[56] That the government cannot compel the use of the accrual method merely because there are inventories unless there has been a reasonable determination that cash basis accounting does not clearly reflect income, see Glenn v. Kentucky Color & Chemical Co., 186 F. 2d 975, 40 A.F.T.R. 139, 51-1 U.S.T.C. ¶9167 (6th Cir. 1951); *contra,* Herberger v. Comm'r, 195 F. 2d 293, 41 A.F.T.R. 907, 52-1 U.S.T.C. ¶9253 (9th Cir. 1952), *cert. denied* 344 U.S. 820; Caldwell v. Comm'r, 202 F. 2d 112, 43 A.F.T.R. 271, 53-1 U.S.T.C. ¶9218 (2d Cir. 1953).

[57] U.S. Treas. Reg. 118, §39.41-2(a).

[58] Aluminum Castings Co. v. Routzahn, 282 U.S. 92, 9 A.F.T.R. 567, 2 U.S.T.C. ¶615 (1930).

[59] Niles-Bement-Pond Co. v. U.S., 281 U.S. 357, 8 A.F.T.R. 10895, 2 U.S.T.C. ¶518 (1930); RABKIN & JOHNSON, FEDERAL INCOME, ESTATE AND GIFT TAXATION ¶12.02(4).

[60] Another writer reports the same condition: VER PLOEG, FARM INCOME TAX MANUAL 22 (1954).

[61] INT. REV. CODE OF 1954, §446(b).

[62] INT. REV. CODE OF 1954, §446(c)(4).

[63] S. REP. NO. 1622, cited at note 51 *supra.*

[64] U.S. Treas. Reg. 118, §§39.42.2, 39.42-3.

[65] The leading case on accrual of income has been Spring City Foundry Co. v. Comm'r, 292 U.S. 613, 13 A.F.T.R. 1193, 4 U.S.T.C. ¶1276. (1934). I sometimes like to test my own thinking by asking whether a court would sustain a demurrer or overrule a motion for judgment on a suit brought on the last day of the taxable year involved. A condition not removed within the year would probably compel a conclusion for the defendant. From this legalistic test, I can conclude that no

doctrines for an accrual basis taxpayer, cash received often produces present taxable income even though a future expensive obligation remains.[66] Even though a cash basis taxpayer has laid out present cash for several years of insurance protection, the expense must be pro-rated.[67] This is the same result as for the accrual taxpayer.[68]

These amalgamations, confusions, gradations and adaptations are applicable generally to most taxpayers. They are problems requiring their own special treatment.[69] Some applications were partially modified by new provisions in Internal Revenue Code §452 and §462. The approximate former status quo was restored by the recent retroactive repeal.[70] Other changes seem to be forthcoming, perhaps soon.

In the major premises, these general principles apply to agriculture. But as everybody knows, farmers are different. A long standing exception has allowed farm income to be reported on the cash basis[71] even though inventories are significant.[72] Farmers on the accrual basis are generally on the same footing as any accrual basis taxpayer except that special inventory valuation methods are available for their use.[73]

At death the cash basis farmer may enjoy another special favor, perhaps unintended. The average taxpayer with inventories is required to accrue the value represented.[74] Accrual of the inventory at the death of the accrual taxpayer is a byproduct of the statutory plan taxing income in respect of a decedent. Its value is taxable as income to the beneficiaries.[75] Not so the farmer on the cash basis: since inventories during life-

income has been realized: the taxability must be postponed until the last condition has been satisfied.

[66] Among numerous possible examples the prepaid rent disputes are typical. As examples of the example, see Rosenbery, *Advance Payments In Sale and Lease Transactions,* 24 TAXES 243 (1946); Morehead, *Real Estate Transactions,* 7 N.Y.U. INST. ON FED. TAXATION 1036 (1949).

[67] A cash basis taxpayer has created an asset having several years' duration. A deduction is allowable only to the extent of the current *pro rata* portion of the premium paid for protection spread over the life of the policy. Comm'r v. Boylston Market Ass'n., 131 F. 2d 966, 30 A.F.T.R. 512, 42-2 U.S.T.C. ¶9820 (1st Cir. 1942).

[68] An accrual basis taxpayer carries the cost ratably to the years for which protection has been paid. Higginbotham-Bailey-Logan Co., 8 B.T.A. 566 (1927).

[69] The literature of taxation has been prolific on this subject for a decade. Two long treatments of the problem are cited at note 3 *supra.* Before these appeared, I collected a group of references in an article. See Boehm, *Adjusted Gross Income,* 27 TAXES 351, note 2 (1949). Most standard tax references contain further development of the varying ramifications of the problem.

[70] Repealed by H.R. 4725, Pub. L. No. 74 (June 15, 1955).

[71] A cash basis farmer *must* file form 1040-F as a supplement to his return. U.S. Treas. Reg. 118, §39.22(a)-7(e).

[72] U.S. Treas. Reg. 118, §39.22(c)-6.

[73] See table B for a synoptic summary of farmers inventory methods.

[74] U. S. Treas. 118, §§39.22(c)-1, 39.41-3(a).

[75] INT. REV. CODE OF 1954, §691. The net tax benefit will depend upon the inventory methods in use. If a farmer is on a cash basis he uses no inventories. As a result his capital gain is larger. See Moen, *Special Capital Gains Treatment For Farmers, infra,* especially text at note 31.

TABLE A

A SELECTED SYNOPTIC COMPARISON OF ELEMENTS OF TAX ACCOUNTING METHODS FOR AGRICULTURE

Characteristics of Method	*Cash Receipts & Disbursements Method*	*Accrual Accounting*
Accounting event for taxability of income. I.R.C. §446(c).	Income is taxable in year when cash or fair market value of cash equivalent is received by taxpayer. I.R.C. §451(a).	Accrual of unconditional and enforceable *right to income* at its fair market value. See note 65.
Accounting event for deductibility of costs. I.R.C. §461(a).	Cost must have been paid within taxable year.	Taxpayer must have incurred an (1) *enforceable liability to pay* an (2) *ascertainable amount* (3) within the year. *U. S. v. Anderson,* 269 U. S. 422, 5 A.F.T.R. 5674, 1 U.S.T.C. ¶155 (1926); *Harrold v. Comm'r,* 192 F. 2d 1002, 41 A.F.T.R. 442, 52-1 U.S.T.C. ¶9107 (4th Cir. 1951).
Deviations from strict application and implications of governing principle. Cf. I.R.C. §§452 & 462 repealed.	Constructive receipt doctrine creates liability even though cash not actually received if right is not restricted. Reg. 118 §§39.42-2 & 39.42-3. (akin to accrual method).	Receipt of prepaid income taxable even though attributable to subsequent periods (akin to cash method).
Accounting for expenses running over several years duration.	Expenditures having a duration of several years must be spread out similarly to accrual. See text at note 67.	For many purposes the rule is the same for both methods.
Necessity of inventories for average taxpayer.	Not needed; method not permissible to non-farmers who have inventories. Reg. 118 §39.41-2 (a).	Required for almost all accrual basis taxpayers. Reg. 118, §§39.22(c)-1; 39.41-3 (a). For methods see Table B.
Necessity of inventories for farmer taxpayer.	No inventories reportable whether or not he has inventories. Reg. 118 §39.22 (a)-7(a).	Required the same as for any accrual taxpayers: Regs. 118 §§39.22(a)-7 (b); 39.22(c)-6.
Complexity of records: no books required for any method. See note 51.	Simplest form; no inventory required.	More complicated; requires account of accrued rights & liabilities. Requires written accounting for inventories. See note 55.
Function in farmers economic position.	Produces diminished income taxes in years of increasing inventories and in decreasing tax rates or heavy income.	Correctly reports income; not subject to cash transactions in or out. Sales feasible whenever market warrants; less artificial bunching. Tax cost lower as tax rates go up. Expenses can be recognized whether cash is paid or not.

Characteristics of Method	*Cash Receipts & Disbursements Method*	*Accrual Accounting*
Relation to farmers cash position & equity.	Usually cash available to pay taxes; not related to over-all net worth.	Taxes are due whether or not cash is available. Tax decrease if value of inventories decline below cost. Compare farm inventory methods, at Table B.
Relative tax advantages when breeding livestock is liquidated for capital gain. I.R.C. §1231(b)(3).	Livestock bred, born and raised by taxpayer is not included in inventory, has no basis; maximum amount receives favored tax treatment as capital gain; but beware the possibility of income bunching.	Livestock bred, born and raised by taxpayer is valued according to the method in use. The special tax treatment is least favorable where the inventories are valued highest.
Principle disadvantages of method.	(a) Possibility of bunching income or corresponding lack of freedom to market resulting from desirability of avoiding bunching. (b) Cash basis does not reflect losses when inventory prices are declining.	(a) Greater complexity, more records. (b) Higher tax cost as inventories rise. (c) Taxes due regardless of cash position. (d) Capital gain advantage reduced by higher basis which cuts amount for special treatment under I.R.C. §1231(b)(3). (e) Inventory is a part of income in respect of decedent.
Permanent avoidance of income tax on increase of wealth not taxed up to owner's death. I.R.C. §§1014 (b) (1), 1014 (b) (9).	Avoidance of taxation of total *fair market value* of inventory arises by new basis acquired from decedent. Costs were deducted during lifetime; there is no death tax on value. These amount to double blessings. This advantage is peculiar to cash basis farmers only. CAVEAT: Does this constitute income in respect of decedent? (I.R.C. §691). See discussion at page— near note 78.	This option does not work in favor of an accrual basis taxpayer since the inventories must be included to determine income. U.S. Treas. Reg. 118, §39.22(a)-7(b).

time are not required of him,[76] observers feel that inventories at death are not includible either in his income or in the income of his successors.[77] Dictum of the Court of Appeals for the Ninth Circuit might mean that this distinction is headed for a sudden end.[78]

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[76] U.S. Treas. Reg. 118, §39.22(a)-7(a).

[77] Young, *Linde Decision Confuses Tax Treatment of Cash Basis Decedent [Farmers] Inventory*, 4 J. TAXATION 160, 44 ILL. BAR. J. 44; VER PLOEG, FARM INCOME TAX MANUAL, 6, 11, citing Burnett, 2 T.C. 897 (1944), *acq.* 1944 CUM. BULL. 4.

[78] Comm'r v. Linde, 213 F. 2d 1, 45 A.F.T.R. 1522, 54-1 U.S.T.C. ¶9384 (9th Cir. 1954) *cert. denied* 348 U.S. 871, commented upon by Miller, *Tax Problems in Estates*, 14 N.Y.U. INST. ON FED. TAX. 331, 332 (1955).

3—Crop Basis Accounting

Some crops have cultivation cycles which extend over more than one year. The most usual examples are sugar cane and pineapples. The accounting method has been described by the Court of Appeals for the District of Columbia.[79]

> In the Hawaiian Islands, a crop of sugar cane is planted in the spring of one year, brought under cultivation in the fall of the following year, and harvested and manufactured into commercial sugar in the third year. During each calendar year, work is being performed on three separate crops[:] the crop that is being harvested, the crop under cultivation which was planted the prior year, and the crop that is then being planted which will be harvested two years thereafter. The crop basis of accounting is in general use on the sugar plantations of the islands, and, under that system, a crop is treated as a venture, and an account kept for each crop. The expenses of the crop from the preparation of the soil to the manufacture of the cane into sugar is charged to the crop account, and all receipts from the crop are credited to the crop account. When the crop is disposed of, it is then determined whether a profit was realized or a loss sustained.

The special method known as *crop basis accounting* is available for taxpayers who first secure from the Treasury special permission for its use.[80] The entire cost of producing the crop, including the rent for the land for the time cycle[81] is charged as a deduction in the year in which the gross income from the crop is realized.[82] Conversely, awards in the nature of insurance for strike damage to the crop are income in the year the cycle is complete even though received in an earlier year.[83] Each crop is treated as an independent unit for which complete cost records are maintained.[84] This treatment seems to be similar to the completed contract method venture accounting and to job cost accounting techniques employed in some industries. In one case, indirect costs were distributed on a direct-labor-hours basis.[85] But an ordinary crop produced by an

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[79] Kekaha Sugar Co. Ltd. v. Burnet, 50 F. 2d 322, 9 A.F.T.R. 1653, 5 U.S.T.C. ¶1583 (App. D.C. 1931).

[80] U.S. Treas. Reg. 118, §39.22(a)-7(d); §39.41-2(c); and §39.23(d)(11).

[81] Kekaha Sugar Co. Ltd., 13 B.T.A. 690 (1928), *modified and aff'd*, 50 F. 2d 322, 9 A.F.T.R. 1653, 5 U.S.T.C. ¶1583 (App. D.C. 1931). But see Ambling-DeVore Nurseries, Inc. v. U.S. (D.C. Cal. 1956) cited at note 90, where the Treasury contended that the taxpayer in effect had adopted the crop method without permission, and should be held to it.

[82] U.S. Treas. Reg. 118, §39.23(a)-11.

[83] Kahuku Plantation Co., 12 B.T.A. 977 (1928), *modified* 13 B.T.A. 292, *acq.* VII-2 CUM. BULL. 21; Oahu Sugar Co. Ltd., 13 B.T.A. 404 (1928); Ewa Plantation Co., 13 B.T.A. 625 (1928).

[84] See note 82, *supra.*

[85] See Brown, 18 B.T.A. 859 (1930); and compare Sewell (1947), CCH Dec. 13732 (M), 3 T.C.M. 106; U.S. Treas. Reg. 118, §39.22(a)-7(c).

ordinary accrued basis taxpayer cannot be held over from one year to the next in order to use crop accounting methods.[86] The explicit language of the regulation requires a characteristic growing cycle of more than a year.[87]

Since prior permission to use the crop method must be secured from the Treasury, in order to prevent double deductions, it is usual practice to require the taxpayer to agree to eliminate expenses previously claimed.[88] If the taxpayer agrees in order to get permission to change, he cannot complain that distortion of his income occurs in the year of changeover.[89]

It is apparent that the several-year-cycle of growth plus the necessary prior Treasury permission will produce only a few rare examples of crop basis accounting.[90]

4—Farm Inventory Practices

"Whenever . . . the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by the taxpayer . . . as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."[91] Wide discretion has been reposed in the Treasury to prescribe the basis for inventory accounting.[92] Only farmers using accrual accounting methods are required to report inventories for purposes of income taxation.[93]

The inventory practices must meet certain general tests:

(1) The items must be subject to reasonable inclusion in the inventory. Thus items for which title is not vested in the tax-

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[86] Kahuku Plantation Co. v. Comm'r, 132 F. 2d 671, 30 A.F.T.R. 655, 43-1 U.S.T.C. ¶9229 (9th Cir. 1942).

[87] U.S. Treas. Reg. 118, §39.22(a)-7(c) permits crop accounting where the producing cycle takes "more than a year from the time of planting to the time of gathering and disposing . . ."

[88] I.T. 2614, 1932-2 CUM. BULL. 48.

[89] Kahuku Plantation Co. v. Comm'r, 132 F. 2d 671, 30 A.F.T.R. 655, 43-1 U.S.T.C. ¶9229 (9th Cir. 1942).

[90] Few litigated cases have reached the courts to raise questions which derive from crop accounting methods. In addition to the authorities cited in this section, see Waimanalo Sugar Co., 12 B.T.A. 1241 (1928), *modified* in 13 B.T.A. 323 (1928); *acq.* VIII-1 CUM. BULL. 47; Kahuku Plantation Co. 43 B.T.A. 784 (1941), *aff'd* Kahuku Plantation Co. v. Comm'r, 132 F. 2d 671, 30 A.F.T.R. 655, 43-1 U.S.T.C. ¶9229 (9th Cir. 1942). We have been told that there are virtually no other crops grown in the United States which fit this pattern. Depending on the farming method used, clover might fit the definition. Their value is so small that no need for special treatment can be expected. See Amling-DeVor Nurseries, Inc. v. U.S., 56-1 U.S.T.C. ¶9389, 1956 P-H FED. TAX SERV. ¶72490 (D.C. Cal. 1956), where the government contended that rose bushes were accountable under the crop basis. The issue seems to be alive but limited, according to Treasury unofficial comment.

[91] INT. REV. CODE OF 1954, §471.

[92] No regulations under the Internal Revenue Act of 1954 have been adopted or proposed. The prior governing provision was INT. REV. CODE OF 1939, §22(c).

[93] U.S. Treas. Reg. 118, §39.22(c)-6.

payer[94] and assets not normally a part of the inventory[95] may not be considered.

(2) An appropriate permanent method of recording the inventory and the pricing must be provided. A good memory is not enough; the inventory must be written.[96]

(3) The inventory must be taken as nearly as may be according to the best accounting practice in the trade or business.[97]

(4) The inventory must "most clearly reflect . . . income."[98]

(5) The method must be used consistently from year to year.[99]

Four standard inventory methods are open to use by the farmer after having made a timely election or secured permission from the Treasury:[100]

(1) Cost;[101]

(2) Lower of cost or market;[102]

(3) Farm-price method;[103]

(4) Unit-livestock-price method.[104]

Familiar principles of costing are more difficult to apply in farming because of a common deficiency of adequate records. The cost of raw materials and supplies, direct labor and ordinary burden[105] including management expenses must be included in cost.[106] Taxes are not includible in the burden element.[107] Farmers may approximate their costs for inventory purposes if they follow the normal established farm practices.[108]

The lower of cost or market method produces an additional train of problems. Market[109] means current bid price but requires appropriate proof. In some limited cases, the direct cost of marketing may be re-

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94 U.S. Treas. Reg. 118, §39.22(c)-1; Brown Lumber Co. v. Comm'r, 35 F. 2d 880, 8 A.F.T.R. 9777 (App. D.C. Cir. 1929); U.S. v. Amalgmated Sugar Co., 72 F. 2d 755, 14 A.F.T.R. 508, 4 U.S.T.C. ¶1339 (10th Cir. 1934).

95 Pierce-Arrow Motor Car Co. v. U.S., 9 F. Supp. 577, 15 A.F.T.R. 8, 35-1 U.S.T.C. ¶9073 (Ct. Cl. 1935).

96 C. E. Clark, B.T.A. Memo, P-H ¶42098, CCH Dec. 12412-F (1942); U.S. Treas. Reg. 118, §39.22(c)-2(e); I.T. 1673, CUM. BULL. June 1923, 30.

97 INT. REV. CODE OF 1954, §471.

98 *Ibid.*

99 U.S. Treas. Reg. 118, §§39.41-2(a), 39.22(c)-2(b).

100 U.S. Treas. Reg. 118, §§39.41-2(c), 39.22(c)-2(b).

101 U.S. Treas. Reg. 118, §39.22(c)-3.

102 U.S. Treas. Reg. 118, §39.22(c)-4.

103 U.S. Treas. Reg. 118, §39.22(c)-6(d).

104 U.S. Treas. Reg. 118, §39.22(c)-6(e).

105 Burden must be included. Garden City Feeder Co., 35 B.T.A. 770 (1937).

106 U.S. Treas. Reg. 118, §39.22(c)-3(c).

107 Taxes are deductible when paid or accrued; they can't be buried in inventory valuations. Years of consistent accounting practice by the taxpayer and by the industry don't make any difference. Montreal Mining Co. 2 T.C. 688 (1944). This rule violates accepted cost accounting practices.

108 U.S. Treas. Reg. 118, §39.22(c)-3(d).

109 U.S. Treas. Reg. 118, §39.22(c)-4(a).

flected in the market value.[110] The computation must be made as to each item separately, and the lower used in each case[111] by groups.

The farm-price method is a device peculiar to tax accounting for farmers; no others may use it.[112] The right to the option is theirs alone; they cannot be forced to use the method.[113] Growing crops are not includible.[114] The valuation is fixed at the current market price[115] at a nearby market[116] reduced by the direct cost of disposition.[117] Permission to change to the method must be obtained from the Treasury[118] but it won't be granted retroactively.[119]

For the single inventory element of livestock[120], since 1944, the Treasury has permitted a further refinement officially termed "the unit-livestock-price method". The taxpayer must establish by adequate records[121] the quantities in the inventory, shall define reasonable classifications for his livestock and must set up reasonable standard unit prices for the animals described.[122] The classic government example described the process.[123]

> If a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the Commissioner upon examination of the taxpayer's return . . .[124]

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110 U.S. Treas. Reg. 118, §39.22(c)-4(b).

111 U.S. Treas. Reg. 118, §39.22(c)-4(c).

112 Moody-Warren Commercial Co., 29 B.T.A. 887 (1934); *cf.* Cornelia Adair, 43 B.T.A. 384 (1941), *acq.* 1941 CUM. BULL. 1, P-H 1941 FED. TAX SERV. ¶66240.

113 Reynolds Cattle Co., 31 B.T.A. 206 (1934), *acq.* XIII-2 CUM. BULL 16.

114 I.T. 1368, I-1 CUM. BULL. 72, O.D. 995, 5 CUM. BULL. 63.

115 U.S. Treas. Reg. 118, §39.22(c)-6(d); Sorelle, 22 T.C. 459 (1954), *acq.* P-H 1955 FED. TAX SERV. ¶77107. A taxpayer's own sales within a week are probative evidence of the current price. Canter, 13 T.C.M. 43, CCH Dec. 20118 (M), P-H T.C. Memo, ¶54028 (1954).

116 Bamert, 8 B.T.A. 1099 (1927); *acq.* VII-1 CUM. BULL. 3; Peterson, T.C. Memo. Dec. CCH 14476, P-H ¶4108 (1945); Alvin, Memo T.C., P-H ¶49102 (1949).

117 See note 115, *supra.*

118 U.S. Treas. Reg. 118, §39.41-2(d).

119 A.R.R. 6207, CUM. BULL. June 1924, 62.

120 The taxpayer might well be using the unit livestock-price method for his livestock, the crop basis (see section III-3) for his sugar cane, and some other inventory method for other parts of his farming.

121 Mim. 5790, 1945 CUM. BULL. 72, reprinted at P-H 1945 FED. TAX SERV. ¶6846(6).

122 U.S. Treas. Reg. 118, §39.22(c)-6(e).

123 U.S. Treas. Reg. 118, §39.22(c)-6(e).

124 For an example of the inventory method at work, see Fawn Lake Ranch Co., 12 T.C. 1139 (1949), *acq.* 1953-1 CUM. BULL. 4, P-H 1953 FED. TAX SERV. ¶76483.

AN ILLUSTRATION OF DIVERGENCIES IN FARM INVENTORY VALUATION METHODS

TABLE B

Item	Cost	Market	Lower of cost or market	Marketing cost	Farm price method	Unit classification previously adopted	Unit livestock price method
A	$10	$14	$10	$1	$13	$15	$15
B	15	10	10	1	9	22	22
C	14	14	14	1	13	30	30
D	12	15	12	1	14	10	10
E	19	12	12	1	11	20	20
Totals	$70	$65	$58	$5	$60		$97
Cost	$70						
Lower of cost or market			$58a				
Farm price method					$60		
Unit livestock price method							$97

Note: These cases are unrealistic because they are entirely imaginary. But the sages have said that truth is stranger than fiction.

a. When a taxpayer has once used the lower of cost or market for inventory pricing, he cannot later use cost when they become depreciable assets. *Bill Smith* T.C. Memo Dec.

The unit price method can be easily adopted without previous permission by accrual basis taxpayers who have been reporting on the basis of cost or lower of cost or market.[125] A cash basis taxpayer must obtain permission to change to any inventory method.[126] The unit-livestock-price method is one application of accrual accounting.[127] Presumably the right to use the method would follow from general permission to shift to accrual techniques. An accrual basis farmer who has been using the farm price method must obtain permission to use the unit-livestock-price method.[128] Once adopted, all animals raised must be so valued whether used for breeding, draft or dairy purposes. To change the classification of animals or unit prices requires special permission.[129] But the method does not apply to purchased animals except that the cost must be increased for age brackets similarly applied.[130] If a purchased animal can be identified at the time of loss or sale, the cost price will control; otherwise first-in-first-out cost will apply.

5—*Amortization of Grain-Storage Facilities*

Farmers will be directly assisted by governmental policy which encourages by tax techniques the construction of facilities for the storage

125 U.S. Treas. Reg. 118, §39.22(c)-6(h).
126 U.S. Treas. Reg. 118, §39.22(c)-6(a), (b).
127 Diamond A Cattle Co., 21 T.C. 1, 5 (1953).
128 U.S. Treas. Reg. 118, §39.22(c)-6(h).
129 U.S. Treas. Reg. 118, §39.22(c)-6(f).
130 U.S. Treas. Reg. 118, §39.22(c)-6(g).

of grain they produce.[131] Unlike the soil and water conservation deduction which explicitly applies only to farmers,[132] "any person who constructs, reconstructs or erects a grain-storage facility . . ."[133] for the storage of grain produced by him . . ."[134] is entitled to special treatment. Enterprisers selling or processing grain in commerce are not covered.[135] The deduction must first be applied to determine adjusted gross income.[136]

At least generally comparable to fast write-offs permitted to industry for some facilities,[137] a sixty-month amortization[138] plan is permitted as

[131] INT. REV. CODE OF 1954, §§169(a) and 169(d)(1). Ohio property tax classification rulings are discussed by Lynn and Oster, *Real Property Taxation of Farm Lands and Structures,* text near note 30, *infra,* page ___.

[132] INT. REV. CODE OF 1954, §175(a): "In General—a taxpayer *engaged in the business of farming* may treat expenditures . . . for soil or water conservation . . . as a deduction . . ."

[133] INT. REV. CODE OF 1954, §169(a)(1).

[134] INT. REV. CODE OF 1954, §169(d)(1). Query: for this purpose can a taxpayer not a farmer produce grain? What about hobby farmers who are not farmers within the meaning of the Code? See note 33 *supra.* We suppose that the term "person" was used in §169(a)(1) and (2) so as to cover both farmers under §169(d)(1) in their function as producers, and also to cover grain elevator operators under §169(d)(2).

[135] The statute seems to apply only to grain storage facilities for producers, INT. REV. CODE OF 1954, §169(d)(1), and elevators, INT. REV. CODE OF 1954, §169(d)(2). We suppose that a food miller, processor, or distiller, usually users of grain, cannot be covered under the elevator provision.

[136] INT. REV. CODE OF 1954, §62(1); U.S. Treas. Reg. 118, §22(n)-1(c).

[137] INT. REV. CODE OF 1954, §168. The amortization plan for defense facilities is generally comparable to the grain storage deduction provision. World War I brought the first use of a similar plan. 40 STAT. 1078; 42 STAT. 255; Revenue Act of 1918, §234(a)(8). The crisis of World War II brought renewed use of the plan. Second Revenue Act of 1940, §302. During the Korean episode, it became a part of the law again. See INT. REV. CODE OF 1939, §124A. Among many comments on the defense facility provisions, see GREEN, *Amortization Of Emergency Facilities,* 10 N.Y.U. INST. ON FED. TAX. 599 (1952). For an exhaustive treatment of amortization of emergency facilities, see 4 MERTENS, LAW OF FEDERAL INCOME TAXATION, §23.124 *ff,* 204.

[138] Amortization is generally equivalent to an accelerated write-off of the cost of assets which would be otherwise normally claimed by depreciation. Arkansas-Oklahoma Gas Co. v. Comm'r, 201 F. 2d 98, 43 A.F.T.R. 120, 53-1 U.S.T.C. ¶9170 (8th Cir. 1953). As used in INT. REV. CODE OF 1954, §169(a), amortization contemplates an allocation of the basis of the grain storage facility on a monthly basis equally over a five year period. In this practical respect it operates quite like the concept of depreciation which is ordinarily related to the useful life of a physical asset. For most purposes, they both work the same way, regardless of the label attached to the computation. The statute contains a restrictive element that "the election . . . shall be made only by a statement to that effect in the return for the taxable year in which the facility was completed . . ."

Notice also that the net effect would seem to require that (1) the earliest date for completion would have been January 1, 1953 and (2) only taxpayers with a fiscal year ended in August, 1953, or later could claim the deduction *in the year of completion.* But the statute also permitted the deduction *in the year following completion.* INT. REV. CODE OF 1939, §124B(b). These alternatives are still available under the new law. INT. REV. CODE OF 1954, §169(b).

to the cost of the grain facilities. The deduction is available for *construction completed* during the period from December 31, 1952 through 1956.[139] The impending presidential election coupled with the noisy concern over the farm vote tempts the conjecture that the later date might be soon extended by amendment to the statute.[140] By contrast the fast write-off permitted to industry under the emergency facilities provision can be cut off only by presidential proclamation.[141]

In order to use the fast deduction, it is necessary that all of these elements coincide:

(1) *The subject matter* technically termed *grain storage facilities* includes only "any corn crib, grain bin, or grain elevator or any similar structure *suitable primarily for the storage of grain . . .*" This would exclude structures not designed for but merely adapted temporarily to grain storage purposes. Land[142] and defense facilities[143] are not amortizable.

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139 INT. REV. CODE OF 1954, §169 was based on the first enactment contained in the Technical Changes Act of 1953, effective August 15, 1953, 67 STAT. 620, assimilated into the INT. REV. CODE OF 1939 as §124B. Regulations covering the former statute appeared in T.D. 6112, 19 C.F.R. 7453, 1954-2 CUM. BULL. 184, P-H 1954 FED. TAX SERV. ¶76999.217.

140 The policy of promoting the construction of grain storage facilities and a comparable but separable device to achieve the erection of defense facilities are two distinct governmental objectives. But from a farmer's viewpoint, wouldn't allowing "his" statutory deduction to expire in 1956 be an act of favoritism to business? Hasn't the administration enough farm troubles without having to defend itself against this charge? The generally more favorable treatment available under the grain storage amortization plan would be as nothing if it expired a few days before the new administration takes office.

141 The "emergency period" during which fast write-off of emergency facilities may be permitted may be ended "on the date on which the President proclaims that the utilization of . . . the emergency facilities . . . is no longer required in the interest of national defense." INT. REV. CODE OF 1954, §168(d)(2).

142 INT. REV. CODE OF 1954, §169(d) excludes land cost by considering only "property of a character which is subject to the allowance for depreciation provided for in §167 . . . [which spells out the ground rules for depreciation]."

143 The section seems to mean that the allowance will not be permitted to coincide with the quick write-off used in defense facilities under INT. REV. CODE OF 1954, §168. Under former law, some assets could meet both tests. It is hard to imagine why a taxpayer would have chosen to buck the restrictive regulations covering defense facilities, with their prerequisite administrative permission, INT. REV. CODE OF 1954, 168(d)(1), and the customary percentage limitation required by most certificates. INT. REV. CODE OF 1954, §168(e)(1). Until late in 1953, the Office of Defense Mobilization had issued emergency defense regulations for grain-storage facilities which permitted fast write-off of 40% of their cost. The new section above was much more generous. If the fast write-off had not been claimed under the defense provisions, the taxpayer was permitted to apply for cancellation of the certificate and to switch to the 100% write-off spelled out in INT. REV. CODE OF 1939, §124(B). Office of Defense Mobilization, 10-12-1953, OD-LS No. 261; Rev. Rul. 227 (1953), 1953-2 CUM. BULL. 177, P-H 1953 FED. TAX SERV. ¶76678, CCH 1953 STAND. FED. TAX REP. ¶6346.

(2) *The taxpayers intention* at the time of making the election must be to use the facility for the storage of grain.
(3) *The taxpayers status as a producer* is prerequisite; the intention must be to make use of the facility "for the storage of grain produced by him ***".[144]
(4) *The taxpayer's time of construction* must have been after December 31, 1952 and before January 1, 1957.
(5) *The taxpayer's legal interest* may be one of several wide categories: any "person who constructs, reconstructs or erects a grain storage facility . . ." may be at his election entitled to a deduction with respect to the amortization of the adjusted basis . . ."[145] "Person", broadly defined in the Code [146] is explicitly extended to a partnership if the facility is intended for the storage of grain produced by the members.[147] Would a lessee who constructs a grain storage facility on the land of another during the lease period qualify to use the deduction?[148] The deduction is available to an estate or trust but it must be apportioned between the income beneficiaries and the fiduciary.[149] In line with familiar statutory patterns, a life tenant gets the entire deduction; the remainderman gets none.[150] In addition, a succeeding owner may qualify to use up the remaining time in the sixty month period if his predecessor had elected to

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Current construction of grain-storage facilities must be handled under the more favorable provisions of INT. REV. CODE OF 1954, §169.

Query; can land cost, not deductible under the grain storage provision, be written off under the defense facility device? Will the government grant the prerequisite permission?

[144] The section continues by including "any public grain warehouse permanently equipped for receiving, elevating, conditioning, and loading out grain, . . ." This seems hardly applicable to a farmer. A grain elevator, to which the statute also applies, is not reasonably includible in an article on *farmers* tax problems.

[145] INT. REV. CODE OF 1954, §169(a)(1).

[146] INT. REV. CODE OF 1954, §7701(a)(1).

[147] INT. REV. CODE OF 1954, §169(d)(1).

[148] The substantive provisions confer the right on *"any person* who constructs . . . a grain-storage facility . . ." [emphasis supplied], INT. REV. CODE OF 1954, §169(a)(1), and "any person who acquires a grain storage facility . . ." INT. REV. CODE OF 1954, §169(a)(2). The catch-lines refer to "original owner" and "subsequent owners." If ownership refers only to a fee simple, the lessee's improvements don't qualify. But the catch-line probably has no legal effect. See INT. REV. CODE OF 1954, §7806(b) which may be applicable. Ownership might reasonably relate to the limited estate represented by the lease and the right to use and possession. And why isn't a lessee "a person"? *Cf.* INT. REV. CODE OF 1954, §7701(a)(1).

[149] INT. REV. CODE OF 1954, §642(f). It passes to the beneficiaries if it has not been consumed by the decedent and the estate or trust. INT. REV. CODE OF 1954, §642(h). But see Miller, cited at note 78, at page 336.

[150] The amortization deduction is totally for the benefit of the life tenant and not deductible by the remainderman. INT. REV. CODE OF 1954, §169(g). The same rule applies to defense facilities, INT. REV. CODE OF 1954, §168(h), depreciation, INT. REV. CODE OF 1954, §167(g), and depletion, INT. REV. CODE OF 1954, §611(b)(2). See also INT. REV. CODE OF 1954, §62(6).

use the fast write-off and if the predecessor had not discontinued the special deduction.[151]

(6) *The taxpayer's formal election to amortize* must, by statute, "be made only by a statement to that effect *in the return* for the taxable year in which the facility was completed . . ."[152] For a succeeding owner, the election must be made in the return for the year in which the facility was acquired. An alternative method permits an election before the filing of the return affected by complying with a method prescribed by the Treasury. Under Regulations promulgated under prior INT. REV. CODE OF 1939, SECTION 124B,[153] considerable latitude was permitted in making the advance election, including delegation of liberal discretion to grant extensions.[154]

SYNOPTIC COMPARISON OF AMORTIZATION OF SPECIAL FACILITIES: DIFFERENCES IN 60 MONTH WRITE-OFFS: CONSEQUENCES INTERNAL REVENUE CODE OF 1954

TABLE C

Difference in Characteristic	*Emergency Facilities* (I.R.C. §168)	*Grain-Storage Facilities* (I.R.C. §169)
Source of right to claim deduction.	Must be secured from administrative authority in response to specific application. I.R.C. §168(e)(1).	May be claimed as a matter of right by any person who meets statutory tests. I.R.C. §169.
Amount of cost which may be amortized.	Limited to element found amortizable by administrative authority. I.R.C. §168 (d)(1).	Entire cost incurred during effective period may be amortized.
Assets includible to determine amount of deduction.	Any permitted assets including land. I.R.C. §168 (d)(1).	Grain storage facilities but excluding land. I.R.C. §169 (d).
Termination of right to deduction for assets to be constructed.	Expires only by Presidential proclamation. I.R.C. §168(d)(2).	Expires for any assets not completed by December 31, 1956. I.R.C. §169 (d).
Acquisition by subsequent owner.	Facility "acquired" may be amortized if certificate issued. I.R.C. §168(b).	Successor can use when predecessor used the option and did not give it up. I.R.C. §169(a)(2).
Treatment of gain from sale of assets.	Portion of gain in excess of straight-line depreciation is taxable as ordinary income; allocation required. I.R.C. §1238.	Capital gain after computation of acquired basis. I.R.C. §1231; 1016(a)(2).

[151] The rights of a subsequent owner are explicitly limited. INT. REV. CODE OF 1954, §169(a)(2), (b), (e)(2).

[152] INT. REV. CODE OF 1954, §169(b).

[153] No regulations have been issued interpreting INT. REV. CODE OF 1954, §169. The prior statute was nearly identical. Regulations based on INT. REV. CODE OF 1939, §124(b) were issued November 19, 1954 after the enactment of the new code. T.D. 6112, 19 C.F.R. 7453, 1954-2 CUM. BULL. 184, P-H 1954 FED. TAX SERV. ¶76999.217. There seems little reason to change these requirements.

[154] Even if the taxpayer didn't meet the deadline prescribed, he can do so later in the return.

The formal election to amortize must:

(1) Be filed in the return for the year in which falls the first month of the 60 month period over which amortization is claimed;
(2) Contain a description of the facility sufficient for clear identification;
(3) State the date on which the construction was completed; pleted;
(4) Summarize the costs paid or incurred excluding the cost of land;
(5) Set out a statement that the taxpayer intends to use the facility for storage of grain produced by him.[155]

Official Form 1040-F contains a provision for inserting information concerning an amortization deduction. A simple explanation in the first affected return might properly state the taxpayer's election to claim the special treatment.

But suppose that a deduction is claimed under the notion that it is a repair or some other deductible expense connected with an eligible facility. Suppose the deduction as claimed is disallowed by Treasury action and that the expenditure is required to be capitalized. Taxpayer might now claim an offset based on the amortizable deduction based upon construction of an appropriate grain storage facility. Has he effected by the original deduction, by whatever name, a sufficient compliance with the statutory requirement that the "election . . . shall be made only by a statement to that effect in the return . . .?" Or must it be explicity labelled and packaged, even to the extent of making alternative claims in the return?[156]

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[155] T.D. 6112, 19 C.F.R. 7453, 1954-2 CUM. BULL. 184, P-H 1954 FED. TAX SERV. ¶76999.217.

[156] INT. REV. CODE OF 1954, §169(b). But by contrast with the strict requirement that the deduction be claimed "in the return," notice INT. REV. CODE OF 1954, §175 which permits the deduction of certain soil and water conservation expenditures. The general subject is discussed at the text at part III-6. The requirements spelled out in the *code section* nowhere require that the *return* be used for the election. But the *regulations applicable* require that the election "shall be made by a statement attached to the *return* . . . [and] shall specify the amount of each type of such expenditure and shall describe them in detail" [emphasis supplied]. T.D. 6118, 1955-3 CUM. BULL. 90, P-H 1955 FED. TAX SERV. ¶23103, CCH 1955 STAND. FED. TAX REP. ¶6114. Does a taxpayer filing a delinquent return meet this requirement? Compare INT. REV. CODE OF 1954 §248(c).

A new election with some similarities first appeared in the INT. REV. CODE OF 1954, §248(c). It permits a corporation to elect to amortize ratably, over an elected period of not less than sixty months, organization expenditures paid or incurred after the enactment of the Code. The Code requires the election to be "made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof)." By regulation, the Treasury requires that the election must be made "in a statement attached to the taxpayers return . . . The statement shall set forth the description and amount of the expenditures and the number of months (not less than 60) . . . over which such expenditures

Having once elected to use the fast deduction, he may change his mind *once* as to future periods by giving to the Treasury, before the beginning of the month involved, notice in writing of his desire to cancel

are to be deducted ratably . . ." T.D. 6118, 1955-3 CUM. BULL. 90, P-H 1955 FED. TAX SERV. ¶23102(7), CCH 1955 STAND. FED. TAX REP. ¶6114.

Here a parallel problem could arise. Some organization expenses such as filing fees paid to the Secretary of State of Ohio on organization (see I.T. 2625, XI-1 CUM. BULL. 25) or reorganization (see I.T. 2570, X-1 CUM. BULL. 115) are deductible as taxes, since they are paid into the general operating funds of the State of Ohio. The problem of what expenses are currently deductible is not always easy to answer. Compare the Ohio rulings with those covering a filing fee paid by corporations to the state of Michigan; these have been held to be not deductible. I.T. 3468, 1941-1 CUM. BULL. 231, P-H 1941 FED. TAX SERV. ¶66225, CCH 1941 STAND. FED. TAX REP. ¶6316. See also the rulings concerning a bonus tax paid to Pennsylvania on an increase of capital stock. Greensburg Coal Co. v. U.S., VIII-2 CUM. BULL. 319, 7 A.F.T.R. 9306 (D.C. Penna. 1929); United Gas Improvement Co., 25 B.T.A. 1382 (1932), *aff'd.* 64 F. 2d 957, 12 A.F.T.R. 474, 3 U.S.T.C. ¶1094 (3d Cir. 1933); and Summerill Tubing Co., 36 B.T.A. 347 (1937). A Tax Court practice of allocating reorganization expenses between capital expenditures and deductible expense appeared in Mills Estate, Inc., 17 T.C. 910 (1952), and again in Tobacco Products Export Corp., 18 T.C. 1100 (1952). The whole practice was condemned and reversed in Mills Estate, Inc. v. Comm'r., 206 F. 2d 244, 44 A.F.T.R. 266, 53-2 U.S.T.C. ¶9525 (2d Cir. 1953) noted in 6 STAN. L. REV. 368 (1954) and 102 U. PA. L. REV. 554 (1954). But in another situation, where a dissolution was followed by reincorporation, deduction was allowed. Arcade Co., Inc. v. U.S., 97 F. Supp. 942, 40 A.F.T.R. 913, 51-1 U.S.T.C. ¶9324 (D.C. Tenn., 1951), *aff'd,* 203 F. 2d 230, 43 A.F.T.R. 652, 53-1 U.S.T.C. ¶9298 (6th Cir. 1953), *cert. denied,* 346 U.S. 828. The rule of the Arcade case was questioned by Judge Frank in Bard-Parker Co., Inc. v. Comm'r, 218 F. 2d 52, 57, 46 A.F.T.R. 1418, 55-1 U.S.T.C. ¶9109 (2d Cir. 1954), *cert. denied,* 349 U.S. 906.

The committee comments tell us that under INT. REV. CODE OF 1954, recapitalization expenses are not deductible. S. REP. NO. 1622, 83rd Cong., 2d Sess. 37, 224 (1954), citing Surety Finance Co. v. Comm'r, 77 F. 2d 221, 15 A.F.T.R. 1373, 35-1 U.S.T.C. ¶9354 (9th Cir. 1935). But reorganization expenses in a taxable reorganization involving a liquidation followed by a reincorporation conceivably might be deductible in spite of INT. REV. CODE OF 1954, §248. Compare Bakst, *Does Dissolution Followed By Reincorporation Constitute a Reorganization,* 33 TAXES 815 (1955).

With this history of turmoil and confusion, possibly helped along by INT. REV. CODE OF 1954, §248, it would be a wise taxpayer who claimed his deduction with the intention of later settling the application of the subtleties and nuances of the cases at the time of the Treasury's examination. But having currently expended the entire item, has he complied with the limitations in the Code section and the Regulations? How important is the detailed statement in this situation? Has he met the time limit inherent in the requirement of the regulation that the election be stated in the return?

Does the claim for deduction in a *return* of the entire expenditure on one rationale amount at least to an equivalent claim for the same amount or a less amount under another rationale? For some discouraging precedents based on *claims for refund,* see U.S. v. Felt & Tarrant Mfg. Co., 283 U.S. 269, 9 A.F.T.R. 1416, 2 U.S.T.C. ¶708 (1931). Where the taxpayer misconceived the proper ground for his refund in a suit to recover a refund, the government can properly deny the refund. Real Estate-Land Title & Trust Co. v. U.S., 309 U.S. 13, 23

the election to amortize.[157] After the notice, depreciation under INT. REV. CODE OF 1954, SECTION 167 is allowable.

The use of the fast deduction probably reduces earnings or profits for corporate taxpayers.[158] It cannot be used in a period other than the year to which it is applicable[159] except of course indirectly through the use of the carryover of the net operating loss deduction.[160]

Perhaps the most amazing effect is the alchemy of converting the tax saving resulting from allowing the deduction into a favorable capital gain upon disposition. A grain-storage facility would almost certainly be a business asset under INT. REV. CODE OF 1954, SECTION 1231. A gain would be taxable as though it were capital in nature and would be measured against the original cost reduced by the quick write-off.[161] This

A.F.T.R. 816, 40-1 U.S.T.C. ¶9184 (1940); Nemours Corp. v. U.S., 188 F. 2d 745, 40 A.F.T.R. 485, 51-1 U.S.T.C. ¶9271 (3d Cir. 1951), and dozens of similar cases cited at P-H. FED. TAX SERV. ¶20053. One court, acting under FED. R. CIV. P. 54(a), has allowed relief which was not claimed in the pleadings. Agarano v. U.S., 110 F. Supp. 609, 43 A.F.T.R. 549, 53-1 U.S.T.C. ¶9313 (D.C. Hawaii 1953).

We know of no rulings that apply the rules to produce such harsh results where the item was not correctly claimed in the return. Concededly, there can be a substantial difference between a return, governed now by INT. REV. CODE OF 1954, §§6011 and 6012, *inter alia,* and a claim for refund which is prerequisite to a judicial suit for refund under INT. REV. CODE OF 1954, §7422(a).

And, finally, will precedents prevail as to other areas? For example, will a decision granting deductibility when arising as to the election in connection with the use of the grain-storage facilities provision control the right to make an election under the corporate organization expense section, or an option to claim under the soil and water conservation provisions? How much similarity of result will flow from the statutory requirement that the election be made in the return under INT. REV. CODE OF 1954, §169(b), and INT. REV. CODE OF 1954, §248(c) as against a similar election *required by regulation* to be in the return but not explicitly so required by statute (INT. REV. CODE OF 1954, §175)?

[157] INT. REV. CODE OF 1954, §169(c). The discontinuation will "begin as of the beginning of any month specified by the taxpayer in a notice in writing filed with the secretary or his delegate before the beginning of such month . . ."

[158] Under the provisions of the World War II defense facility amortization deduction, it was held that the use of the fast write-off served to reduce the earnings or profits of the taxpayer corporation. I.T. 3543, 1942-1 CUM. BULL. 111, P-H 1942 FED. TAX SERV. ¶66170, CCH 1942 STAND. FED. REP. ¶6279. There seems to be no reason why the result would be different under the grain storage section and the 1954 meaning of earnings or profits. The term "earnings or profits" has acquired a detailed meaning from administrative and judicial interpretation over many years. See INT. REV. CODE OF 1954, §316. Although the term has been slightly altered by new provisions in the Internal Revenue Code of 1954 the changes do not seem to affect this facet. See *e.g.,* INT. REV. CODE OF 1954, §312.

[159] A defense facility deducation can be used only in the year in which it was allowable. Voit Rubber Corp. v. U.S., 110 F. Supp. 277, 43 A.F.T.R. 490, 53-1 U.S.T.C. ¶9228. (D.C. Cal. 1953). Presumably this rule would apply equally to the grain facilities deduction.

[160] INT. REV. CODE OF 1954, §172.

[161] The basis of property shall be the cost . . ." INT. REV. CODE OF 1954, §1012. It must be "adjusted as provided in section 1016." INT. REV. CODE OF 1954, §1011. "Proper adjustment in respect of the property shall in all cases be made

is the startling difference between the two fast write-off methods: by explicit command of the statute, *emergency defense facilities* at taxable sale or disposition produce ordinary income to the extent of the extraordinary write-off in excess of straight-line depreciation.[162]

In effect, the treatment as capital gain which applies to grain storage facilities divides the tax by half for individuals limited in all cases to not more than 25% of the taxable gain.[163]

6—*Soil and Water Conservation Expenditures*

Development costs and expenditures prior to the productive state of a farm have long been regarded as capital items.[164] New provisions[165] now provide for limited deduction by farmers or owners[166] of expenditures for soil and water conservation purposes even though they should have been capitalized under other established principles of law.[167]

Conservation costs include direct expenditures by the taxpayer[168] for non-depreciable assets.[169] They also include indirect costs to satisfy a conservation assessment[170] not otherwise deductible by the taxpayer.[171]

. . . (2) . . . for . . . amortization . . . to the extent of the amount (A) allowed as deductions in computing taxable income . . ." INT. REV. CODE OF 1954, §1016(a).

[162] "Gain from the sale or exchange of property, to the extent that the adjusted basis . . . is less than its adjusted basis determined without regard to section 168 (relating to amortization deduction of emergency facilities) shall be considered as . . ." ordinary income. INT. REV. CODE OF 1954, §1238. *Cf.* the ancient maxim *descriptio unius est exclusio alterius.*

[163] INT. REV. CODE OF 1954, §1201.

[164] U.S. Treas. Reg. 118, §39.23(a)-11.

[165] INT. REV. CODE OF 1954, §175.

[166] The deduction can be claimed as to any land used in farming used by the taxpayer as owner-operator or as landlord devoted to "the production of crops, fruits or other agricultural products or for the sustenance of livestock . . ." INT. REV. CODE OF 1954, §175(c)(2).

[167] Terracing a productive farm to prevent erosion was held to be deductible in Collingwood, 20 T.C. 937 (1953), *acq.*, P-H 1954 FED. TAX SERV. ¶76573, CCH 1954 STAND. FED. TAX REP. ¶6302.

[168] Conservation costs deductible include but are not limited to "leveling, grading and terracing, contour furrowing, the construction, control and protection of diversion channels, drainage ditches, earthen dams, water-courses, outlets, and ponds, the eradication of brush, and the planting of windbreaks . . ." INT. REV. CODE OF 1954, §175(c)(1).

[169] Conservation expenditures do not include the cost of depreciable assets or any amount deductible under other provisions of the law. INT. REV. CODE OF 1954, §§175(c)(1)(A) and 175(c)(1)(B). From this it is apparent that cumulative relief is intended. In the case of other applicable deductions, the taxpayer will not be forced to rely only on this section.

[170] INT. REV. CODE OF 1954, §175(c)(1) particularly permits deduction of an allocable amount "to satisfy any part of an assessment levied by a soil or water conservation or drainage district to defray expenditures made by such district . . ." S. REP. No. 1622, 83rd. Cong., 2d Sess. 216 (1954) contemplated an allocation between conservation expenditures, tax deductions and depreciable assets.

[171] This liberalization is akin to the expansion of the tax deduction concept to cover local benefit assessments covering an entire county and affecting 100

The use of the deduction amounts to an election to follow an accounting method.[172] The election must be claimed in the first year after 1953 during which the taxpayer has made expenditures.[173] To change in subsequent years, approval by the Treasury must be secured.[174] Taxes for conservation purposes (§171), maintenance and repair expenses are deductible irrespective of the election.[175]

An eligible farmer may deduct up to 25% of his gross income[176] derived from farming[177] during the taxable year.[178] This would seem

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persons subject to a uniform levy according to value. INT. REV. CODE OF 1954, §164(b)(5)(B).

[172] INT. REV. CODE OF 1954, §175(e).

[173] INT. REV. CODE OF 1954, §175(d).

[174] INT. REV. CODE OF 1954, §175(d)(2).

[175] Rev. Rul. 54-191, 1954-1 CUM. BULL. 68, P-H 1954 FED. TAX SERV. ¶76753, CCH 1954 STAND. FED. TAX REP. ¶6302.

[176] The deduction is based solely upon gross income. Net income, which limits depletion allowances (INT. REV. CODE OF 1954, §613(a)) is irrelevant. The unlimited carry forward in INT. REV. CODE OF 1954, §175(b) stands alone. By contrast, depletion can't be carried forward. It can be taken to another year only as a part of a net operating loss deduction. INT. REV. CODE OF 1954, §172(c), §172(d). S. REP. No. 1622, 83rd Cong., 2d Sess. 31, 211 (1954).

[177] "Gross income derived from farming . . ." (INT. REV. CODE OF 1954, §175(b)) does not seem to be elsewhere defined in the Code. Regulations under former law defined "gross income of farmers" very broadly with no mention of the costs of production. U.S. Treas. Reg. 118, §39.22(a)-7.

Possibly production costs must be considered to determine gross income from farming in the same way that costs of goods sold must be used in determining gross profits of a merchandising business.

The computation of gross income subject to the constitutional taxing power of Congress must take into account the cost of goods sold; to fail to allow the full deduction has been held to amount to a tax on capital. Doyle v. Mitchell Bros. Co., 247 U.S. 179, 3 A.F.T.R. 2979, 1 U.S.T.C. ¶17 (1918). The deduction therefore is required under the *income* sections of the Code. INT. REV. CODE OF 1954, §61(a); formerly INT. REV. CODE OF 1939, §22(a). The *deduction* sections provide other problems but in general, it is likely that Congress can withhold or condition the benefits of a deduction. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 13 A.F.T.R. 1180, 4 U.S.T.C. ¶1292 (1934).

This distinction and the continuing need under constitutional doctrine to allow the deduction of the total cost of goods sold can be epitomized. Consider as an excellent example the struggle revolving around an attempt during national emergency periods to disallow illegal payments of over-ceiling costs for goods sold. Without exception, against the strong resistance of the Treasury, the deduction has been permitted, usually for statutory reasons, several times because of constitutional limitations traceable to the *Mitchell Bros.* rule. The Tax Court led the way in 1948, Lela Sullenger, 11 T.C. 1076 (1948). For several years, in several cases, it stood alone against the Treasury's non-acquiesence. I.T. 3724, 1945 CUM. BULL. 57, P-H 1945 FED. TAX SERV. ¶76174, CCH 1945 STAND. FED. TAX REP. ¶6174; Krekstein and Ferst, *The Income Tax and Over-Ceiling Transactions,* 25 TAXES 700 (1947); Krekstein, *Deductibility of Over-Ceiling Payments,* 6 N.Y.U. INST. ON FED. TAX. 703 (1948). Appeals from the decisions were slow developing. Once started, the cases have held unanimously in favor of deductibility of cost of goods sold usually as a matter of constitutional right, even though the cost in-

to include all income from several farms owned by a taxpayer even though the expenditures were made on only one property.[179] If the expenditures exceed the deductible portion of gross income, the unused expenditure can be carried forward indefinitely for use in later years subject to the overall annual 25% limitation.[180] Furthermore, the deduction can be used to create a net operating loss[181] and may be carried back two previous years and ahead five subsequent years. [182] Full amount

cluded over-ceiling payments. Comm'r v. Weisman, 197 F. 2d 221, 41 A.F.T.R. 1388, 52-1 U.S.T.C. ¶9353 (1st Cir. 1952); noted, *Costs In Violation of Ceiling Prices Held Deductible* (1952), 2 BUFFALO L. REV. 162 (1952); Hofferburt v. Anderson Oldsmobile, Inc., 197 F. 2d 504, 42 A.F.T.R. 38, 52-1 U.S.T.C. ¶9358 (4th Cir. 1952) *affirming* 102 F. Supp. 902, 41 A.F.T.R. 830, 52-1 U.S.T.C. ¶9190, noted, *Excludability From Gross Income of Payments Over Ceiling Price,* 6 VAND. L. REV. 128 (1952); Comm'r v. Guminski, 198 F. 2d 265, 42 A.F.T.R. 367, 52-2 U.S.T.C. ¶9411 (5th Cir. 1952); and Jones v. Herber, 198 F. 2d 544, 42 A.F.T.R. 523, 52-2 U.S.T.C. ¶9397 (10th Cir. 1952).

The Internal Revenue Service has finally acquiesced in this result. I.T. 4104, 1952-2 CUM. BULL. 71, 952, P-H 1952 FED. TAX SERV. ¶76421, CCH 1952 STAND. FED. TAX REP. 6336, overruling a former contrary position announced in I.T. 3724, 1945 CUM. BULL. 57, P-H 1945 FED. TAX SERV. ¶76174, CCH 1945 STAND. FED. REP. ¶6174.

But perhaps, in the price violation cases, there is no constitutional problem at all. In a concurring opinion, the obiter remarks of Chief Judge Magruder give reason to wonder. *Comm'r v. Weisman, supra,* at page 224: "I hope the courts opinion will not give the impression that there is any serious doubt of the constitutional power of Congress to exclude from the offset so much of the cost of goods sold as represented payment by the taxpayer in excess of the applicable ceiling price . . ." See also Circuit Judge Strum dissenting in *Comm'r* v. *Guminski, supra,* at page 266.

Congress has laid the groundwork for a challenge to these propositions. By explicit provision in the Defense Production Act of 1950, 64 STAT. 798 (1950), as amended, 66 STAT. 296 (1952), 50 U.S.C. §2061, by 65 STAT. 136 (1951), 50 U.S.C. §2105(A), particular authority was accorded to the President to disallow payment in excess of ceilings including the entire amount of any such payment. There is a difference of opinion as to the constitutionality of such legislation. Compare note, *Disallowance of Over-Ceiling Costs of Goods Sold: The Defense Production Act of 1950,* 4 SYRACUSE L. REV. 323 (1953), with the reasoning of Judge Magruder *supra.*

Query how much application will this history have in determining "gross income from farming"? What costs will be subject to the implicit dichotomy?

178 INT. REV. CODE OF 1954 §175(b).

179 S. REP. No. 1622, 83rd. Cong., 2d Sess. 217 (1954). A favorable comparison may be drawn to the limitations surrounding the computation of percentage depletion. Depletion at stated percentages is based upon *"gross income from the property . . ."* (INT. REV. CODE OF 1954, §613(c)) but not to "exceed 50 percent of the taxpayer's taxable income *from the property . . ."* (INT. REV. CODE OF 1954, §613(a)). [Emphasis supplied] The necessity for separating producing properties and the right to a limited aggregation are regulated by INT. REV. CODE OF 1954, §614. Compare INT. REV. CODE OF 1954, §175(c)(2).

180 INT. REV. CODE OF 1954, §175(b).

181 INT. REV. CODE OF 1954, §172(c).

182 "[O]f course, any amount allowable as a deduction under . . . [INT. REV.

of the permissible deduction must be claimed if the election is made. For some years the conservation deduction taken together with the net operating loss carryover may actually create a deduction which produces no tax benefit. An unused deduction because of inadequate gross income does not increase the basis of the farm[183] except where the election has not been made; then it produces an adjustment to basis.[184]

This election gives considerable leeway for intelligent farm development with a computable assist from the government. In effect, a farmer can spend tax free for conservation one-fourth of his entire gross income from farming over the years. In addition, by a net operating loss carryback, he might get fresh money from tax refunds from years gone by to help to finance the cost. These indirect subsidies will appeal to persons who wish to build values for the future with cheap tax money. They help most the high-bracket taxpayer. They will not hurt taxpayers in those cases where they are affected by the application of the limitation forbidding annual losses in excess of $50,000 for five consecutive taxable years.[185]

AN ILLUSTRATION OF THE AMORTIZATION OF SOIL & WATER CONSERVATION EXPENDITURES MAXIMUM DEDUCTIONS & CARRY FORWARDS INTERNAL REVENUE CODE OF 1954, §175

TABLE D

Taxable year	Gross income from farming	Soil & water conservation expenditures this year	Deductible as carryover from previous years. First expenditure or Treasury permission now effective.	Maximum deductible: up to 25% of gross income from farming	Conservation expenditure carried forward
1956	$10,000	$3,000		$2,500	$ 500
1957	8,000	1,000	$ 500	1,500	—0—
1958	8,000	2,000	—0—	2,000	—0—
1959	6,000	2,500	—0—	1,500	1,000
1960	6,000	1,000	1,000	1,500	500

IV—POLITICAL FAVORITISM OR ENLIGHTENED PUBLIC INTEREST?

Do any of these technical provisions suggest a political cynicism? Sample two opinions, both of which are probably partially right.

> Our pampered tyrant, the American farmer . . . forms the most powerful vested interest in the American economy . . . [B]ig helpings of government gravy are going to about two million farmers—many of them corporations—who grow

CODE OF 1954, §175] either in the year of expenditure or in a year to which carried, in a year producing a net operating loss will become a part of the loss and be eligible to be carried back 2 years and forward 5 . . ." S. REP. No. 1622, 83rd. Cong., 2d Sess. 216, 33 (1954).

183 S. REP. No. 1622, 83rd. Cong., 2d Sess. 216, 33 (1954).

184 INT. REV. CODE OF 1954, §1016(a)(1).

185 INT. REV. CODE OF 1954, §270(b) excludes expenditures as to which the taxpayers are given the option to deduct or to capitalize. See Burford, *Investing in Herds, Farms and Ranches,* U. SO. CALIF. TAX INSTITUTE 369, 374 (1954).

> 85% of the total farm output. They *operate a little more than a third of the* farms . . . This cynicism is probably justified. The record of recent elections indicates that the farmer is generally eager to sell his vote to the highest bidder . . . But don't blame the politicians for this record. They didn't invoke it. We did—all of us . . .[186]

Whether or not this point of view can be squared with the general fact situation (over this, there was political protest[187] and farmer dissent),[188] special tax treatment for farmers in special areas can be rationalized on various intellectual premises.

> The desire might be to subsidize . . . activity without general public realization that this was the case; a technical tax provision could be devised that would achieve the result . . .[189]
>
> The tendency is to extend tax favors to more and more taxpayers . . . Tax exemptions and other specially favorable treatment, however, are very likely to spread beyond their original scope . . . [In time they are] likely to become so deeply entrenched in the law that . . . other taxpayer groups . . . argue that in order to achieve equity, Congress should extend to them the same favorable treatment . . . The result is a departure from the logical definition of the tax base and a deterioration of the tax system . . .
>
> The tendency for favorable tax treatment makes 'incentive taxation' largely an illusion. An amazing number of groups of taxpayers appear before tax policy makers with proposals to promote the prosperity of the country by granting some special tax exemption to them . . . if a number of the proposals are adopted, the stimulating effect of any one is reduced . . .[190]

Does this seem like a particular polemic against the farmer like that in the Country Slicker argument? It wasn't meant to be, but it does seem to describe, at least a little, some of the technical plans contained in the substantive portions of this article. We found interesting and refreshing Blough's conclusion respecting the farmer and the tax collection:

> Agricultural groups have had less to say about federal tax

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[186] Quoted at random from various portions of an article by "J.F.", *The Country Slickers Take Us Again,* 211 HARPERS MAG. 21-23 and emphasis supplied. (December, 1955). A group of letters printed in 212 HARPERS MAG. 4, (February, 1956) included one signed "Ezra Taft Benson, Secretary of Agriculture, Washington, D.C." which characterized "the article by John Fisher in the December issue . . . [as being] excellent."

[187] The Benson appraisal of the article was repudiated after he was criticized by Senators Humphrey (Democrat, Minnesota) and Young (Republican, North Dakota) who demanded his immediate dismissal from the President's Cabinet. *U.S. News & World Report,* 16, (February 3, 1956).

[188] See critical correspondence addressed to the *Country Slicker* article, 212 HARPERS MAG. 5-8, (February, 1956).

[189] BLOUGH, THE FEDERAL TAXING PROCESS, 417 (1952).

[190] *Id.* at 425.

> programs than have labor or business organizations . . . In 1951, several of the national farm organizations testified . . . rather closely in support of the Treasury's recommendations, more so than that of the labor organizations and much more so than that of the business organizations.[191]

The Treasury generally is the only representative of the general public in the consideration of tax legislation, aside from pressure groups professing to represent public interests which they often claim are largely coterminous with their own.[192]

This pat on the back should be encouraging to the friend of the farmer. For a more cynical last word, if farmers as a group have generally argued on behalf of the public interest, it may be because several of the policies discussed in this symposium have already been set in their favor, along with other favored groups.[193] In this election year, we wonder whether direct subsidies in several of these areas wouldn't be a more attractive selling price to the farmer who would be "generally eager to sell his vote to the highest bidder . . ."[194]

Finally, years after the farmer was busy cutting down his taxes by reducing gross income through ignoring inventory, and by piling up deductions under gimmick laws, some will surely be affected by the new social security benefits. Self-employment income fixes the maximum benefits payable; self-employment income is computed from the tax return.[195] A heavy pencil in the last years before retirement might later prove expensive through smaller benefit checks.

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[191] *Id.* at 40.

[192] *Id.* at 120 ff, 7, 40.

[193] For an interesting collection of examples of group, individual and sectional favoritism at work in the code, see the good extended treatment of Cary, *Pressure Groups And The Internal Revenue Code: A Requiem In Honor of The Departing Uniformity of The Tax Laws,* 69 HARV. L. REV. 745 (1955).

As this goes to press, we notice the interesting article by Randolph Paul, who points out that the special favors and tax gimmicks have (1) reduced the effective higher tax brackets to a practical sham; (2) operated unfairly against some few who haven't obtained special deals; (3) eroded the tax base so that major surgery is needed to restore symmetry; (4) opened the door for more pressures; (5) complicated the law by the gimmick devices. For good reading, see Paul, *Erosion of the Tax Base and Rate Structure,* 11 TAX L. REV. (Mar. 1956).

[194] From *The Country Slicker, supra* note 186.

[195] For persons approaching age 65 or retirement, the impulse to use the speedup deductions may be affected by the need for a maximum of $4200 of self employment annual income needed to produce the maximum in social security benefits. INT. REV. CODE OF 1954, §1402(a): compare §312(g).